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Supreme Court of the United States.

OCTOBER TERM, 1931.

No. 348

UNITED STATES CARTRIDGE COMPANY Petitioner,

v.

THE UNITED STATES.

BRIEF FOR UNITED STATES CARTRIDGE COMPANY, Petitioner.

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Supreme Court of the United States.

OCTOBER TERM, 1931.

UNITED STATES CARTRIDGE COMPANY, PETITIONER.
v.
THE UNITED STATES. } No. 348.

BRIEF FOR UNITED STATES CARTRIDGE COMPANY, Petitioner.

I.

THE OPINION OF THE COURT BELOW.

This case comes before the Court for hearing on the merits on a writ of certiorari issued to review a judgment of the Court of Claims.

The opinion in the Court of Claims is reported in 48 F. (2nd) 983. It is printed at pp. 88–110 of the record in this case.

II.

JURISDICTION OF THIS COURT.

The jurisdiction of this Court is based on the Judicial Code, section 240, as amended by Act of February 13, 1925 (43 Stat. 936). The material portion of this section is as follows:

"(b) In any case in the Court of Claims, including those begun under section 180 of the Judicial Code, it shall be competent for the Supreme Court, upon the petition of either party, whether Government or claimant, to require, by certiorari, that the cause, including the findings of fact and the judgment or decree, but omitting the evidence, be certified to it for review and determination with the same

power and authority, and with like effect, as if the cause had been brought there by appeal."

The petition in the Court of Claims was brought to recover an alleged overpayment of Federal income and profits taxes for 1918 amounting to $843,589.12, with interest. The petitioner alleged that the Commissioner of Internal Revenue had made three errors in computing the petitioner's income for 1918 which resulted in the assessment of excessive taxes for that year. There was, however, but one cause of action and the errors claimed affected merely the amount of the judgment to be entered, if any. The Court made special findings of fact and on those findings ruled in the petitioner's favor with respect to the first of the alleged errors and in favor of the United States with respect to the other two. Final judgment for the petitioner was entered in the Court of Claims on June 10, 1931, for $160,978.83 with interest (R. 200). The amount of this judgment corrected the first alleged error but not the second or the third. The petition for a writ of certiorari was filed on September 3, 1931, and granted on November 23, 1931.

III.

STATEMENT OF THE CASE.

The petitioner alleged in the suit in the Court of Claims that the Commissioner of Internal Revenue (hereafter called "the Commissioner") had made the following errors in determining its taxes for 1918, namely, (1) An error in overvaluing a certain Maxim contract inventory by $195,362.67; (2) An error in overvaluing certain inventories relating to contracts with the United States by $500,473.19; and (3) An error in disallowing $327,937.35 of a deduction claimed on account of the cost of certain buildings erected for war purposes on leased land.

The judgment for the petitioner in the Court below covered the full amount claimed on account of the overvaluation of the Maxim (or Italian) inventory, but nothing more. The petition

for certiorari raises issues bearing on the question as to whether the Court should have entered judgment for a larger sum which would have given relief to the petitioner on account of the other two errors alleged. The amounts of income and taxes involved (exclusive of interest) are shown in the statement which follows. All the taxes assessed have been paid (Findings 3–6, R. 59–60).

Total taxes assessed by Commissioner (Finding 4, R. 59)		$1,152,123.53
Reduction by Court of Claims on account of Maxim inventory (R. 200)		160,978.83
Net tax according to decision of Court of Claims		$991,144.70
Net income as determined by Commissioner (Finding 4, R. 59)	$1,792,432.58	
Reduction in income on account of overvaluation Maxim inventory ($274,659.78–79,297.11 — Finding 20, R. 66)	195,362.67	
Net income according to decision of Court of Claims	1,597,069.91	
Income involved in pending suit:		
Deduction for cost of buildings (Finding 49, R. 79–80) $327,937.35		
U. S. inventory question ($732,088.62–231,615.43 Finding 41, R. 76) 500,473.19		
Sum of these deductions	828,410.54	
Net income, after deducting items in dispute		768,659.37
Amount by which tax according to decision of Court of Claims exceeds entire net income as claimed by petitioner		222,485.33

Excess profits tax credit (Finding 4, R. 59)	$369,464.68
War profits tax credit (Finding 4, R. 59)	461,080.84

Under Revenue Act of 1918, secs. 301(a), 230(a), 236, taxes on all income in excess of the war profits credit ($461,080.84) amount to 80% of such income for the war profits taxes and excess profits taxes, plus 12% of the remaining 20% of such income (or 2.4%) for income taxes, or a total of 82.4% of such income. As the petitioner had income aside from the items in dispute which exceeded the war profits credit, it follows that the amounts of taxes involved in the pending questions are:

Cost of buildings deduction (82.4% of $327,937.35)	$270,220.38
U. S. inventory question (82.4% of $500,473.19) .	412,389.91

The petitioner complied with all requirements as to filing claims for refund and with all other formal requirements, and the right to recover depends only on how the disputed items should be treated in computing the petitioner's income for 1918 (Opinion of the Court, R. 58, 88–89, Special Findings 1–8, R. 58–61, 110a–115; cf. petition, par. 26, R. 41). The facts relating to these items are stated below.

The Deduction on Account of Cost of Buildings Erected on Leased Land.

For many years before the World War began in 1914 the petitioner had been engaged in the manufacture of ammunition for small arms to be used for ordinary peace-time purposes. Its business was of a very modest size, employing between 350 and 400 persons. It was carried on principally in buildings at Lowell, Massachusetts, which the petitioner rented from the Wamesit Power Company. The market for the petitioner's product was limited. Its business was highly competitive and was not profitable during the years 1911 to 1914 inclusive,

before it began production for war purposes (Special Finding 43, R. 77).

For the purpose of filling war orders which the petitioner had received, and expected to receive while the war continued, the petitioner, at its own expense, constructed buildings upon land of the Wamesit Power Company at Lowell and at South Lowell, Massachusetts, under an agreement by which the petitioner was entitled to occupy these buildings free of rent for ten years from January 1, 1915, and at the end of the ten years they should become the property of the Wamesit Power Company. These buildings will be referred to in this brief as the "new buildings." The cost of these buildings to the petitioner was $802,499.49, nearly all of which was spent in 1915 and 1916 (Special Findings 44–45, R. 77–78).

When the petitioner built these buildings it had no use for them except for war purposes. During the World War the petitioner had a large and profitable business in war ammunition, first, for European governments and, later, for the United States. Its employees increased to about 15,000, and the space occupied was about five times what had been required before the war. The petitioner used all the new buildings up to the time when the United States entered the war and during the years 1917 and 1918. Up to the time of the Armistice, November 11, 1918, the petitioner had orders up to its capacity and had no way of knowing when the demand for war ammunition would stop. After the Armistice, the petitioner received no new orders for military ammunition, did not expect any, and did not expect to continue production of military ammunition to any material extent (Special Findings 46–47, R. 78–79).

After the Armistice the petitioner continued its commercial ammunition business. Its position with respect to this business was difficult, as each of the five munition manufacturers in the country had a large excess capacity. The peace-time business differed in essential respects from the war business. The war business came to the manufacturer. There was no

selling to be done. Production was confined to a few types in large volume. In the commercial ammunition business, both in the pre-war and post-war periods, there were a large number of kinds of articles made for all varieties of arms. Competition was severe and keen and the industry was believed to be declining. After 1918 the petitioner made no profit in its manufacture of commercial ammunition during any of the years included in the period of the lease (Special Findings 50–52, R. 81–82).

No income could be derived by renting the new buildings, as there was no demand for them. Most of the buildings originally rented from the Wamesit Power Company had been so incorporated into the new buildings that the two had to be used as united unless the plant was revamped and this was not considered or done. The petitioner had in the new buildings and in those which it rented more space than it needed for its commercial ammunition business. In an attempt to utilize the space which the petitioner found on its hands, it undertook the manufacture in the buildings in question (except a garage) of certain articles which it had not made before the war, including radiators, radiator tubes, phonograph motors, paper boxes and certain other articles, in addition to commercial ammunition. The volume of this new business was small compared with the petitioner's commercial ammunition business. The petitioner made no profit from these other businesses but suffered a loss in each year (Special Finding 51, R. 81).

Among the buildings in question was a garage which the petitioner built for the trucks and automobiles used in its war business. It had no need for the garage before or after its war business. After the war the petitioner attempted to operate this building as a public garage but realized no net return. It was rented to others from October, 1923, until the end of the lease, a period of fifteen months (Special Finding 56, R. 83).

The Commissioner of Internal Revenue allowed depreciation for the years 1914–1917 inclusive on account of the cost of these new buildings, amounting in all to $197,107.74. The depreciated cost of these buildings at the end of 1917 was $605,391.75 (cost, $802,499.49, less depreciation, $197,107.74). In the settlement of its 1918 income and profits taxes, the petitioner claimed that the value on December 31, 1918, of its right to use these buildings for peace-time purposes for the remainder of the lease was $190,969.86. The Court of Claims has found that the value on December 31, 1918, of such right to use the buildings did not exceed this amount (Special Findings 53, R. 82). The petitioner claimed that it was entitled to deduct for the year 1918 the difference between the depreciated cost of said buildings at the end of 1917, $605,391.75, and the residual value at the end of 1918, $190,-969.86, making a deduction of $414,421.89 for the year 1918. The Commissioner refused to allow any deduction for loss of useful value of these buildings, ruling that the petitioner was not entitled to it because it had not abandoned the use of the buildings or permanently devoted them to a radically different use. The Commissioner allowed a deduction of $86,484.54 for the year 1918 on account of the cost of these buildings and disallowed the remainder of the petitioner's claim, namely $327,937.35. The allowances for depreciation made by the Commissioner were calculated at such a rate that at the expiration of the lease the cost of each building would be extinguished in equal annual instalments (Special Finding 49, R. 79).

The effect of the disallowance by the Commissioner of $327,937.35 of the deduction claimed was to increase the petitioner's taxes for 1918 by 82.4% of that amount. (See p. 4 above.)

In its income tax returns for the years 1919–1924, which were the remaining years of the lease, the petitioner claimed deductions on account of the new buildings amounting in all

to $190,969.86, which was the residual value on December 31, 1918, of the right to use the buildings during the remainder of the lease as claimed by the petitioner. The Commissioner, in determining the taxes for the years 1919–1924 increased the deductions claimed for those years by the $327,937.35 which he had disallowed for the year 1918 (Special Finding 49, R. 79–80). The effect of this was to throw this deduction into years in which the petitioner, if it had any taxable income, would be taxed at relatively low rates, and to deprive the petitioner of it for the year 1918 when it made a difference in taxes of 82.4% of the deduction.

The Court of Claims sustained the Commissioner (Opinion of the Court, R. 101–110).

The Inventories Acquired for use under Contracts with the United States.

The petitioner kept its accounts on an accrual basis and duly elected that its inventories should be priced at cost or market whichever was lower (Special Findings 2–3, R. 59).

At the end of the year 1918 the petitioner had on hand a large quantity of raw materials and work in process which had been acquired by the petitioner for use in manufacturing ammunition to be supplied to the War Department under four contracts and a supplementary agreement which are described in Special Finding 21, R. 67–69). Copies of the contracts and agreement (hereinafter called "contracts") are included in the record (pp. 120–174; see index to record p. ii). A list of the contracts follows:

Contract No.	*Date*	*Articles to be delivered*	
P6489–1489Sa	May 6, 1918	60,100,000	.45 caliber cartridges
First supplement to P6489–1489Sa		75,000,000	.45 caliber cartridges
P12289–3034A	July 20, 1918	8,760,000	49-gr. artillery primers
GA-126	Aug. 22, 1917	5,000,000	110-gr. artillery primers
P12621–3124A	July 25, 1918	1,000,000	110-gr. artillery primers

The issue which arose as to these inventories was whether they should be valued at their market value on December 31, 1918, ($231,615.43) or at the amount used by the Commissioner of Internal Revenue in assessing additional taxes upon the petitioner in 1926 ($732,088.62). The Commissioner's valuation represented what the petitioner eventually realized from these inventories as a result of negotiated settlements with the United States made in the years 1920–1922.

Each contract in question contained a cancellation clause by which the Chief of Ordnance had an option to cancel the contract under certain circumstances. If he did so the contracts gave the petitioner certain rights, including the right to receive payment at cost for raw materials and work in process on hand. Under each of these contracts, except the supplement to P6489–1489Sa and GA–126, the petitioner also had the right, if the Chief of Ordnance exercised the option given by the cancellation clause, to continue to manufacture for thirty days after notice of cancellation, and under contract GA–126 it had the right to convert the contract into a cost plus contract. (See Special Finding 21, R. 67–69; copies of contracts P6489–1489Sa, article V; P12289–3034A, article XIV; GA–126, article VII; P12621–3124A, article XIV, R. 125, 141, 153, 170.)

The Chief of Ordnance did not exercise these options to cancel. Instead, he sent to the petitioner written requests (called "suspension requests") to suspend production under the respective contracts with a view to settlements by negotiation. Each suspension request contained substantially the following language:

> "This request is made with a view to negotiation of a supplemental contract providing for the cancellation, settlement and adjustment of your existing contract in a manner which will permit of a more prompt settlement and payment than will be practicable under the terms of said existing contract."

Copies of these requests are annexed to the petition filed

in the Court of Claims (exhibits E, F, G, H, R. 52–56). The petitioner received these requests in December, 1918, and complied with them and suspended production under all the contracts (Special Finding 22, R. 69).

On December 31, 1918, the petitioner had on hand material and work in process, constituting the inventories in question, which had been acquired and worked for the purpose of manufacturing the articles specified in these contracts, and which, because of such suspension requests, would not be required in making completed articles (Special Finding 23, R. 69). It was not possible for the petitioner to use such inventories advantageously by manufacturing them into the articles for which they had been intended, as there was no market for such articles. There was no way in which the petitioner could get back what the inventories had cost, except by settlements with the United States. The material in these inventories was not salable at any price approaching cost (Special Finding 24, R. 70).

The petitioner contended that this material and work in process should be valued as of December 31, 1918, at its market value, which was $231,615.43 (Special Findings 41–42, R. 76–77). In the year 1926, the Commissioner of Internal Revenue, in assessing additional taxes upon the petitioner for 1918, valued this material and work in process at $732,088.62. This amount was a composite figure, made up of three elements, (1) cost for such portions of the inventory as were taken over at cost by the United States as a result of various settlement contracts which were made in 1920–1922, (2) the amount received in such settlements for certain material which was paid for in these settlements at less than cost, and (3) the fair market value on December 31, 1918, for such material only as was not taken over in the settlements (Special Finding 41, R. 76). By valuing these inventories at $732,088.62, instead of their market value ($231,615.43), the Commissioner increased the apparent taxable income of the petitioner for 1918

by $500,473.19 and thereby increased the petitioner's taxes by 82.4% of this amount. (See p. 4 above.)

At the end of 1918 the prospects as to whether the petitioner would obtain settlements of its contracts were wholly uncertain. This appears from the history of the negotiations which led up to the settlements of 1920–1922. The details of this history are contained in Special Findings 25–40, R. 70–76. A condensed statement follows.

During the year 1918 no settlement was made of any of the contracts, and no negotiations took place other than the suspension requests. No policy was adopted by the War Department until March 6, 1919, which permitted a settlement for an inventory under a suspended contract where the parties could not agree upon the settlement of the contract as a whole. The petitioner had substantial claims under each contract for items other than inventories, which remained unsettled until the time of the final settlements of the respective contracts. Although partial settlements were made in 1920, the first final settlement was made in December, 1921 (Special Findings 25–27, R. 70).

In February, 1919, the Ordnance Department assigned a committee to the petitioner's plant for the purpose of settling its contracts. The petitioner negotiated with this committee and other Government agencies which subsequently took over its work, with the result that agreements were made in the year 1920 that the United States would take over and pay for most of the petitioner's inventories of raw material and work in process. In the year 1920 the United States took over the greater part of such materials and paid for them at cost, excepting the cost of labor and overhead on the material in process (Special Findings 28–33, R. 70–72). There were at the time many unsettled differences between the parties as to the amounts to be allowed for such labor and overhead. There were also certain inventory items which the United States would not at the time accept or pay for. In the final settle-

ments in 1921 and 1922, the United States agreed to pay for some of these items and declined, on various grounds, to reimburse the petitioner for any loss on others. In some instances a compromise was made by which the petitioner was reimbursed for a part of the cost of certain items, and received no reimbursement for the balance (Special Findings 33–34, R. 72).

The preparation and presentation of the petitioner's claims under its various war contracts in accordance with the requirements of the War Department, and the Government audit of those claims, required a large amount of work extending over several years. The petitioner had claims against the United States under war contracts other than those described above, including a cost plus contract (known as No. 14066) which was much larger than the contracts described above taken together. The petitioner at times employed as many as thirty-five or forty persons on its claims, and spent approximately $400,000, exclusive of legal expenses, in meeting the requirements of the War Department as to the proof of its claims under its various contracts including, among others, contract 14066 and the contracts involved in the present case (Special Finding 85, R. 73).

A number of obstacles in the way of the settlement of some or all of the petitioner's contracts appeared during the negotiations. One of these related to contract P6489–1489Sa, which was by far the most important contract involved. (See Special Finding 38, R. 75.) That contract had been modified by a supplemental agreement (printed at R. 132) by which the quantity of cartridges to be delivered had been increased and the specifications in the original contract had been somewhat changed. The original contract was a properly executed written agreement which complied with Revised Statutes, sec. 3744, but the supplemental agreement was not. The War Department treated the original contract, as amended, as one not executed in accordance with law. The difficulty with respect to payment for undelivered material which would

have resulted from this ruling was removed by the Dent Act (40 Stat. 1272) which was passed on March 2, 1919; and contract P6489–1489Sa and its supplement were settled under procedure established to cover contracts not executed in accordance with law (Special Finding 30, R. 71).

Other obstacles which threatened the success of the negotiations for settlement of the petitioner's contracts are stated in detail in the findings of the Court below (Special Findings 33–34, 36–37, R. 72–74). These included the probability that the War Department agencies which were dealing with the petitioner's claims would be dissolved before these claims could be presented; and the probability that no appropriations which could be used for payment of claims under suspended contracts would be available long enough to permit the payment of the petitioner's claims, with the exception of a claim for cost of unworked materials under contract P6489–1489Sa, which was settled and paid for in January, 1920, at a time when appropriations were expected to be available (Special Findings 32, 36–37, R. 71–74). As it turned out, the agencies of the War Department for the settlement of claims under suspended contracts were continued, and Congress renewed the appropriations for payment of such claims, so that the War Department was able to make the final settlements and to pay the petitioner for its inventories in accordance with them.

After the final settlement contracts were made in 1921 and 1922, the United States still withheld $52,591.05 of the amount agreed to be paid under two of these contracts, and applied it to an alleged overpayment for finished goods under one of the contracts. In 1926, the petitioner recovered this amount as the result of a suit in the Court of Claims (Special Finding 39, R. 75).

The Court of Claims sustained the Commissioner in valuing the inventories in question on December 31, 1918 at $732,088.62 instead of at their market value ($231,615.43).

IV.

SPECIFICATION OF ERRORS.

The petitioner contends that the Court below erred in the following respects:

1. The Court below erred in not allowing the petitioner a deduction of $327,937.35 from its gross income for 1918 on account of the cost of buildings erected by the petitioner on leased land, in addition to the deduction of $86,484.54 which was allowed by the Commissioner of Internal Revenue.

2. The Court below erred in denying to the petitioner a deduction from its gross income for the year 1918 on account of the cost of buildings erected by it on leased land in addition to the deduction of $86,484.54 allowed by the Commissioner of Internal Revenue.

3. The Court below erred in failing to rule that in determining the petitioner's income for the year 1918, the inventories of the petitioner on hand at the end of that year, which the petitioner had acquired for use under its contracts with the United States which had been suspended, should be valued at their market value on December 31, 1918.

The foregoing are the fundamental errors claimed by the petitioner which are intended to include the following subsidiary errors which are assigned:

4. The Court below was in error in holding and ruling that the use which was made by the petitioner of its buildings after 1918 was a bar to a deduction for obsolescence in addition to the deduction of $86,484.54 allowed by the Commissioner of Internal Revenue.

5. The Court below was in error in holding and ruling that under the terms of the cancellation clauses in the petitioner's contracts with the United States, the petitioner became entitled during the year 1918 to be paid for its inventories at cost.

6. The Court below was in error in holding and ruling that the inventories of the petitioner intended for use under its contracts with the United States should be valued as of the end of the year 1918 according to the amounts received for them in settlements made in later years.

7. The Court below was in error in holding and ruling that the decision of the Board of Tax Appeals in *Producers Fuel Co.*, 1 B. T. A. 202 was applicable to the case at bar.

V.

SUMMARY OF ARGUMENT.

A. The deduction on account of the cost of buildings erected for war purposes on leased land should be allowed.

The question between the parties is whether, as claimed by the petitioner, enough of the cost of these buildings should be charged off by the end of the war years to bring their book value down to what they were worth for peace-time purposes during the remainder of the lease; or whether, as claimed by the Commissioner, the cost of these buildings should be charged off solely on a time basis, so as to allocate an equal amount to each of the years of the lease. The petitioner maintains that, as these buildings were built solely for war production, the first method is the reasonable one. As bearing on this question the petitioner submits:

1. The decision in the case of *Burnet* v. *Niagara Falls Brewing Co.*, 282 U. S. 648, supports the deduction which is claimed by the petitioner.

2. The fact that the petitioner's buildings became obsolete for the purpose for which they were built within a single tax year is not a bar to the deduction claimed.

3. The allowances made by the Commissioner in the years 1919–1924 on account of the cost of the buildings are not a bar to relief.

B. The petitioner's inventories acquired for use under its contracts with the United States should have been valued on December 31, 1918, at their market value, $231,615.43.

1. On December 31, 1918, it was wholly uncertain what would become of these inventories and the petitioner had no contracts under which it was entitled to deliver these inventories and to be paid for them.

a. On December 31, 1918, the inventories did not include anything which was to be used to make such completed articles as were called for by the contracts.

b. On December 31, 1918, the petitioner had no contracts with the United States by which the United States agreed to accept these inventories and to pay for them at cost.

c. On December 31, 1918, it was wholly uncertain whether the petitioner would reach any settlements of its contracts and whether, if it did, the settlements would involve the taking over of the inventories and payment for them at cost.

d. Up to the time of the partial settlements made in 1920 the petitioner had no agreement that its inventories would be taken over and paid for at cost, and up to the time of the final settlements made in 1921–1922, the amount which the petitioner was to be paid was unliquidated.

2. Under the circumstances which existed the inventories should have been valued at their market value on December 31, 1918, ($231,615.43) and not at the amount ($732,088.62) which was realized for them in later years through the settlement agreements.

a. The income which Congress intended to tax by the Revenue Act of 1918 was income which was so realized as to be available to the taxpayer according to ordinary business usage and the petitioner's inventories were so available only at their market value.

b. The system of taxation contained in the Revenue Act of 1918 is based on an annual accounting period; and the petitioner's inventories should therefore be taken at their value at the end of 1918.

c. According to good accounting practice, which is recognized by the Revenue Act of 1918 and by the regulations as a standard, these inventories should be valued at their market value.

d. The regulations which relate to the valuation of inventories and to the proceeds of the settlement of claims on Government contracts require that these inventories be valued at their market value.

e. The argument that valuing the inventories at market permits the petitioner to take a loss before it is sustained is not valid.

C. The statutes and regulations should be liberally construed in favor of the taxpayer.

VI.

ARGUMENT.

The two questions involved require separate treatment. The points relating to the deduction claimed on account of the cost of buildings erected on leased land will be stated first, and then those relating to the value of inventories under the United States contracts.

A. In determining the petitioner's taxes for the year 1918, the deduction of $327,937.35 claimed by the petitioner on account of the cost of buildings erected for war purposes on leased land should have been allowed.

The statute involved is section 234(a) of the Revenue Act of 1918 the material portion of which reads as follows:

"Sec. 234 (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions . . .

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; . . .

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;"

Copies of the regulations referred to by the parties are printed in the appendix to this brief. They include Regulations 45, articles 143, 161, 162 and 165. Article 109 of these regulations, on which the respondent relied in the Court below, is also printed in the appendix.

In this case it is conceded that the petitioner has a right to charge off the entire cost of these buildings by the end of the ten year period of the lease. The only controversy between the parties is as to the method by which this shall be done. The Commissioner maintains that it must be done mathematically, so as to charge off each year the same proportional part of the cost of each building. The petitioner maintains that as these buildings were constructed for its war business and the petitioner had no use for them for its ordinary business, the greater part of the cost ought to be charged against the war period, and that against the period which came after the war only that portion of the cost should be charged which represents the fair value of the right to use them for that period.

The most significant facts which have a bearing upon these claims are the following:

The petitioner constructed the buildings in question solely for war uses. It had no use for them for its normal peace-time business and had not been making any money in that business (Special Findings 43, 46, R. 77–78).

It constructed these buildings on leased land under an agreement that they should revert to the landlord at the end of the lease on December 31, 1924. Their usefulness to the petitioner was therefore bound to end by that definite date at the latest (Special Finding 44, R. 77).

These new buildings were all used by the petitioner up to the time of the Armistice and the petitioner had orders up to that time to its capacity and had no way of knowing when the demand for ammunition for war purposes would stop (Special Finding 47, R. 79). For that reason the petitioner was unable, up to the year 1918, to charge off in any year more than a proportionate part of the cost based on charging off the total cost by December 31, 1924.

After the Armistice and as a result of it, the petitioner's officers had no expectation of continuing the manufacture of ammunition for war purposes for which the buildings had been built, and received no new orders for military ammunition and did not expect any (Special Finding 47, R. 79).

No income could be derived by renting the new buildings as there was no demand for buildings of this character (Special Finding 51, R. 81).

The new buildings had been so incorporated into the buildings rented by the petitioner from its landlord that the two had to be used as a unit unless the plant was revamped, and this was not considered or done (Special Finding 51, R. 81).

In an effort to get some return out of the buildings during the last six years of the lease (1919–1924) the petitioner used them in its commercial (peace-time) ammunition business and for certain other new businesses which it attempted to carry on. None of these businesses proved profitable and the petitioner obtained no net return from these attempts to use the buildings (Special Finding 51, R. 81).

The depreciated cost of the buildings at the beginning of 1918 was $605,391.75. At the end of 1918 the actual value of the right to use the buildings for the remainder of the lease did not exceed $190,969.86 (Special Findings 49, 53, R. 79, 82).

Under these circumstances the petitioner charged off on its books for the year 1918 the difference between the depreciated cost, $605,391.75, and the residual value of its property, $190,969.86, or $414,421.89, and claimed a deduction of this amount

in its income tax returns. The Commissioner of Internal Revenue ruled that the petitioner was not entitled to this allowance because it had not abandoned the buildings or permanently devoted them to a radically different use. He therefore allowed only $86,484.54 for depreciation of the buildings for 1918. This allowance was based on charging off an equal amount each year throughout the lease and took no account whatever of the change in conditions which resulted from the Armistice (Special Finding 49, R. 79–80). The result of the Commissioner's method is to allocate to the war years (1915–1918) $283,592.28, or 35% of the cost of the buildings, and to the later years $518,907.21 or 65% of this cost. The method used by the petitioner allocates $611,529.63, or about 76% of the cost to the war years and $190,969.86, or about 24% to the later years. In view of the facts that these buildings were built solely for war production and the petitioner at the time had no other use for them (Finding 46, R. 78) it is apparent that the latter method is more reasonable. An accurate accountant or business man would certainly charge off enough of the cost of such buildings at the end of 1918 so that they would be carried on the books for no more than their real value for peace-time purposes. The Court of Claims specifically found that the value of the right to use the buildings for the remainder of the lease after December 31, 1918, did not exceed $190,969.86 (Special Finding 53, R. 82). Nevertheless, the Court sustained the Commissioner in allocating deductions to various years on a purely proportionate basis. The reasons assigned by the Court are discussed in connection with the points stated below.

1. The decision in the case of Burnet v. Niagara Falls Brewing Co., 282 U. S. 648, supports the deduction which is claimed by the petitioner.

In *Burnet* v. *Niagara Falls Brewing Co.*, it was held that a corporation engaged in making beer was entitled to an allow-

ance for obsolescence of its brewery buildings arising from national prohibition, although the company continued to use them in making soft drinks after prohibition went into effect. This case is similar in all essential respects to the case at bar.

In the *Niagara Falls Brewing Company* case, the buildings had been acquired or constructed for the purpose of making beer. The company could find no use for the property after national prohibition went into effect, except for the purpose of making near beer and other soft drinks. The company began the manufacture of near beer in 1917 and manufactured substantial quantities of near beer in the plant until 1921. In 1921 the company sold some of its land and its remaining property was leased at a small rental. Finding that it could not make any profit in near beer and soft drinks, the company ceased business in December, 1921. It was contended by the government that the use of the plant for making near beer after national prohibition went into effect in January, 1920, prevented any allowance for obsolescence. The Court held that the use which was made of the property after prohibition went into effect was not a bar to such an allowance, and that the sums received on the sale and as rents constituted mere salvage to be taken into account in determining the amount of obsolescence.

This case is similar in all essential respects to the case at bar. In both cases the buildings were acquired for a particular purpose, for which they could no longer be used. In the *Niagara Falls Brewing Company* case the cause of the change was statutory prohibition. In the case at bar the cause was the complete stopping of the demand for war ammunition which resulted from the Armistice. The opinion of the Court of Claims attempts to distinguish the *Niagara Falls Brewing Co.* case on the ground that that case was one where use of the buildings for the purposes intended was prohibited by law and the buildings were "not readily adaptable to other uses" (R. 108–109). It is submitted that this distinction is not sound. The opinion

in the *Niagara Falls Brewing Co.* case clearly treats loss of trade as one of the changes which may result in obsolescence and also shows that the buildings in that case were adaptable to making soft drinks. (See opinion in *Burnet* v. *Niagara Falls Brewing Co.* 282 U. S. 648 at pages 652, 654.)

Another reason advanced by the Court of Claims is that the allowance of annual depreciation made by the Commissioner would eventually return the cost of the buildings and therefore no other allowance for obsolescence was necessary (R. 106, 109). This reasoning fails to distinguish between the ordinary allowance made on a time basis (ordinary depreciation and exhaustion) and obsolescence, which is a more rapid loss of value caused by change of circumstances. A taxpayer who constructs a building is always entitled to a deduction for ordinary depreciation. Similarly a tenant who erects buildings on leased land which will become the property of the landlord at the end of the lease is always entitled to proportionate annual allowances for exhaustion.

> *Duffy* v. *Central R. R. Co. of New Jersey*, 268 U. S. 55, cf. Art. 109, Regulations 45, printed at page 104 of record.

Burnet v. *Niagara Falls Brewing Co.* is a clear authority for the allowance of obsolescence in excess of ordinary depreciation in the year in which the buildings ceased, because of changes in trade, to be useful for the purposes for which they were built or acquired. It was undoubtedly true in that case that if no obsolescence had been allowed, the taxpayer might in course of time have obtained allowances equivalent to the cost of its buildings through losses incurred on sales or through ordinary depreciation. This did not prevent the allowance of obsolescence at the time when it occurred. Similarly in the case at bar, the fact that the annual allowance made by the Commissioner would eventually return the cost of the buildings should not prevent a reasonable allowance for 1918

on account of the complete change in trade caused by the end of the war.

Another reason relied on by the Court of Claims is that obsolescence should not be allowed when buildings are continued in use by their owner (Opinion, R. 105–109). It is submitted that this reasoning is entirely inconsistent with the decision in the *Niagara Falls Brewing Co.* case. In reply to the contention that obsolescence begins only when there is a reasonable certainty that the property cannot be used by the owner *for any purpose*, the opinion in the *Niagara Falls Brewing Co.* case states, "There is no hard and fast rule, as suggested by the Government, that a taxpayer must show that his property will be scrapped or cease to be used or useful for any purpose, before any allowance may be made for obsolescence . . . The company was unable to find any profitable use to which the property could be put. The sums received on the sale and as rents constituted mere salvage." (See Opinion, 282 U. S. 648, at pp. 655, 656.)

It is to be noted that there is nothing in the language of the statute which makes total abandonment of the property a condition of an allowance for obsolescence.

The Commissioner of Internal Revenue cannot by regulations or otherwise lawfully impose a condition as to abandonment which is not found in the statute.

United States v. *George*, 228 U. S. 14.
International Railway Co. v. *Davidson*, 257 U. S. 506.
Campbell v. *Galeno Chemical Co.*, 281 U. S. 599, 610.

The Court of Claims also relied on a number of decisions of the Board of Tax Appeals (R. 106–108). The objection to the use of these decisions as authorities is that they represent a line of cases inconsistent with the decision of this Court in the *Niagara Falls Brewing Co.* case. It should be noted that the *Niagara Falls Brewing Co.* case originated in the Board of Tax Appeals, and was there decided adversely to the taxpayer

on the ground that no allowance for obsolescence on brewery property could be made where it was continued in use by the taxpayer after prohibition. (See *Niagara Falls Brewing Co.* 13 B.T.A. 1040 at 1049.) Prior decisions of the Board of Tax Appeals based on a similar rule were

Yough Brewing Co., 4 B.T.A. 612.
Star Brewing Co. Inc., 7 B.T.A. 377.
Tennessee Fibre Co., 15 B.T.A. 133.
Marigold Garden Co., 6 B.T.A. 368.
McCabe Lathe & Machinery Co., 9 B.T.A. 1137.

It would seem that until the Board of Tax Appeals has rendered a decision with respect to obsolescence which takes into account the decision of this Court in the *Niagara Falls Brewing Co.* case, citations from opinions of the Board of Tax Appeals on the issue now presented cannot be of assistance.

2. The fact that the petitioner's buildings became obsolete for the purpose for which they were built within a single tax year is not a bar to the deduction claimed.

A suggestion is found in a quotation contained in the opinion of the Court of Claims that obsolescence is intended to care for losses of capital which take place over a longer period than a taxable year. (See quotation from *Tennessee Fibre Co.*, 15 B. T. A. 133, R. 106.)

While it is true that obsolescence may take care of losses extending over more than one tax year, there is nothing in this quotation or in the statute to warrant the inference that obsolescence is confined exclusively to such losses, or that a taxpayer cannot have any allowance for obsolescence which begins and ripens into obsoleteness within a single year.

It is not conceivable that Congress meant to give a deduction to a taxpayer who sustained a loss which occurred partly in one year and partly in another, and to deny such a deduction to another taxpayer who had a similar loss which all happened

within one year. There was undoubtedly a period of several weeks before the Armistice in which it was apparent that the end of the war was near. It happened that this period fell entirely within the months of September, October and November, 1918. It might well have happened that the period would have included December, 1918, and January, 1919. There is no reason for applying different rules in the two cases. Obsolescence which ripens into obsoleteness within a single tax year is as clearly within the language of section 234 (a) (4) and (7) as is similar obsolescence which begins in one year and ripens into obsoleteness in the succeeding one.

In the case at bar it is clear that up to the year 1918 no one could foretell how long the war would last or how long the plaintiff's buildings could be used in making war munitions. The Commissioner of Internal Revenue properly refused to permit the petitioner to deduct more than a proportionate part of the cost of its war plant in years preceding 1918 (Special Finding 48, R. 79).

It is to be noted that the new buildings were all used by the petitioner up to the time of the Armistice and the petitioner had orders up to that time to its capacity. With the Armistice the petitioner's war business came to an end. The petitioner's officers then had no expectation of continuing the manufacture of ammunition for war purposes and received no new orders for military ammunition and did not expect any (Special Finding 47, R. 79).

3. The allowances made by the Commissioner of Internal Revenue in the years 1919–1924 on account of the cost of the buildings are not a bar to relief.

In the Court below it was argued for the respondent that if the petitioner should now obtain the allowances claimed for 1918 there would be a double deduction, as the Commissioner allowed for the years 1919–1924 deductions aggregating the amount which he disallowed for 1918. This argument ignores

the findings that the allowances for later years were not claimed by the petitioner but were made by the Commissioner on his own motion as a result of his disallowance of the claim made for the year 1918; and that when he made this disallowance for 1918, the taxes for all the later years were still open, as the petitioner had waived the statute of limitations (Special Finding 49, R. 80–81). The state of affairs which now exists was one which the Commissioner deliberately created with all the facts before him. He allowed these deductions in years when the rates of tax were so low that they made very little difference to the petitioner, and disallowed an equivalent deduction in 1918 when the taxes involved amounted to 82.4% of the deduction. The Commissioner could not, by forcing upon the petitioner deductions in later years which were not asked for, deprive the petitioner of a deduction to which it was entitled in 1918. Furthermore, the petitioner has no intention of obtaining a double deduction. Counsel was authorized to state, and did state in writing in the Court below, that if the deduction claimed for 1918 was finally established and a corresponding refund of taxes obtained, the petitioner would pay or cause to be paid such added amounts of tax, if any, as might be due for later years (either under the petitioner's returns or under consolidated returns which included the petitioner's income) because of any restatement of such deductions for later years which might be necessary in order to avoid duplication of the same allowance. Under this offer it is to be understood that in case taxes for later years have been finally settled, those years are to be opened up only as to items which the final judgment in this suit would result in changing and only to the extent that changes in such items are required as a result of such judgment.

B. The petitioner's inventories acquired for use under its contracts with the United States should have been valued on December 31, 1918, at their market value, $231,615.43.

The Commissioner, in determining the petitioner's taxes for 1918, valued these inventories at $732,088.62, which was the amount realized. This was a composite figure made up of the amount realized for these inventories in later years through the settlement agreements together with the market value of that portion of the inventories which the Government eventually declined to take over in the final settlements (Special Finding 41, R. 76). There is no dispute as to the market value of this inventory on December 31, 1918. The Court of Claims has found that it was $231,615.43 (Special Finding 42, R. 77). The issue between the parties is whether this inventory should be valued on December 31, 1918, at its market value at the time, or at the amount which was eventually obtained in consequence of the settlements made several years later. The effect of using the larger valuation adopted by the Commissioner is to increase the taxable income of the petitioner in the year 1918 by the difference between the two figures, or $500,473.19, and to increase the taxes for 1918 by 82.4% of that amount. (See page 4 above.)

The statute involved is section 203 of the Revenue Act of 1918 which reads as follows:

> "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The material regulations are Regulations 45, articles 22–24 and

1582–1584 (as amended by Treasury Decision 3296); and Regulations 65, articles 1612–1614 (identical with said articles 1582–1584) and article 50. The material portions of these regulations are printed below at pp. 42–44.

The facts concerning the question now presented are summarized in this brief at pages 8–13. As is shown below, it is clear from these facts that on December 31, 1918, it was wholly uncertain what would become of the inventories in question; and also that on that date the petitioner had no contracts under which it was entitled to deliver these inventories and to be paid for them. It also appears that up to the time of the partial settlements made in 1920 the petitioner had no agreement that its inventories would be taken over and paid for at cost and that up to the time of the final settlements made in 1921–1922 the amount that the petitioner was to be paid was unliquidated.

1. On December 31, 1918, it was wholly uncertain what would become of these inventories and the petitioner had no contracts under which it was entitled to deliver these inventories and to be paid for them.

a. On December 31, 1918, these inventories did not include anything which was to be used to make such completed articles as were called for by the contracts.

The articles to be delivered under the contracts were cartridges and artillery primers. The inventories in question included only raw materials and work in process which were not needed in order to complete the limited number of finished articles which the suspension requests permitted the petitioner to furnish. (Special Findings 23–24, R. 69–70.)

b. On December 31, 1918, the petitioner had no contracts with the United States by which the United States agreed to accept these inventories and to pay for them at cost.

The opinion of the Court of Claims was apparently written in a belief to the contrary. The Court below states:

> "The United States contracts clearly disclose 'firm sales contracts at fixed prices' and while the contracts were subject to cancellation, they contained express covenants upon the part of the United States to save the plaintiff harmless in so far as the cost of materials, etc., entering into its inventory is concerned. The contracts contained express provisions setting forth with exactness how the plaintiff should be paid, and the items included within the Government's liability to pay." (R. 97–98.)

In reaching this conclusion the Court of Claims has overlooked the terms of the original contracts and of the suspension requests and the decision of this Court in *College Point Boat Corporation* v. *United States*, 267 U. S. 12. The contracts are listed on page 6 of the printed record. Copies are printed in the record beginning at pages 120, 132, 134, 146 and 163. The respective cancellation clauses of the contracts are printed at pages 125 (Art. V), 134 (Art. IV), 141 (Art. XIV), 153 (Art. VII) and 170 (Art. XIV). The suspension requests are printed as exhibits E, F, G and H at pages 52–56.

An examination of the cancellation clauses and of the suspension requests shows clearly that the Chief of Ordnance by the suspension requests was not exercising rights given by the cancellation clauses. A typical cancellation clause is Article XIV of contract P12289–3034A, beginning on page 141 of the record. This clause recites that it is desirable that provision be made for the cancellation of the contract in the event of the termination or limitation of the war or in anticipation thereof and provides that at any time the Chief of Ordnance may for any of the causes stated notify the contractor that any part of the articles remaining then undelivered shall not be manufactured or delivered. The clause further provides that in the event of such complete or partial termination the United

States shall accept all completed articles then on hand and such as may be completed within thirty days after such notice and pay the contract price therefor; and that the United States shall also pay to the contractor the cost of the materials and component parts purchased by the contractor for the performance of the contract and then on hand, and all costs incurred by the contractor in the performance of the contract remaining unpaid, together with such added sums as the Chief of Ordnance may deem necessary to compensate the contractor. The suspension notice under this contract is printed at page 54 of the record. It contains no recital that any of the causes specified in the contract exist. It makes no provision for continuing operations for thirty days as provided in the termination clauses of the contract, but on the contrary requests the petitioner to suspend further operations immediately.

The second paragraph of the suspension notice states, "This request is made with a view to the negotiation of a supplemental contract providing for the cancellation, settlement and adjustment of your existing contract, in a manner which will permit of a more prompt settlement and payment than will be practicable under the terms of said existing contract." This paragraph makes it clear that the suspension request is made not as a termination under the existing contract, which would give the contractor specific rights set out in the cancellation clause, but with a view "to the negotiation of a *supplemental contract* providing for the cancellation, settlement and adjustment" of the existing contract in a manner different from that specified in the contract. The paragraph speaks of a "more prompt settlement and payment than will be practicable under the terms of said existing contract."

The third paragraph of this suspension notice requests the petitioner to acknowledge receipt of the notice immediately "and indicate your decision as to compliance with or rejection of this request." This paragraph also clearly shows that the

Chief of Ordnance was not exercising the option to cancel contained in the original contract. If he had been doing this, it would not be necessary for the petitioner to indicate "its compliance with or rejection of this request." The petitioner would have had no option as to whether it would or would not accept the cancellation notice under the contract. The Chief of Ordnance clearly was not intending to give such a notice.

One reason why the Chief of Ordnance did not give the termination notice called for by the contract was undoubtedly that the War Department found itself at the end of the war with more munitions on hand than it needed. If the War Department had exercised the options contained in the cancellation clauses of its various contracts, the United States would have had to pay for thirty days production of goods of which it already had a surplus. Accordingly, the Chief of Ordnance preferred to stop production more quickly than he could have done under the termination clauses and adopted the suspension requests as a means of so doing.

The petitioner complied with the suspension requests (Special Finding 22, R. 69). The situation in the case at bar was then precisely that which existed in *College Point Boat Corporation* v. *United States*, 267 U. S. 12. In that case the Navy Department, which had a statutory right to cancel a contract, failed to give the notice requisite to cancel the contract. The Department did, however, request the contractor to stop operations and asked it to submit a proposition for cancellation of the contract. As was observed in the opinion (at page 15), "Its sole objective in suggesting that preparations for the performance of the contract be stopped was to avoid useless production. The Corporation necessarily acquiesced. The parties negotiated, seeking to find a basis on which they could agree to cancel and liquidate the obligation of the Government. In the negotiations, and in the agreements which embodied the partial settlement, the Navy used language inconsistent with an intention to exercise a right of cancellation."

Another decision which upholds the rule that cancellation clauses must be strictly complied with is *Valente* v. *Weinberg*, 80 Conn. 134. To the same effect see *Burton Coal Company* v. *United States*, 60 C. Cls. 294.

As the original contract in the case at bar contained no provisions for the delivery of unfinished articles, except the cancellation clauses, and as the options to cancel were not exercised, it is impossible to support the conclusion of the Court of Claims that the original contracts provided "with exactness how the plaintiff should be paid, and the items included within the Government's liability to pay."

The situation which existed on December 31, 1918 was that the plaintiff had suspended production under its existing contracts at the request of the Chief of Ordnance; that it knew that the United States did not intend to permit any further deliveries of completed articles except as specified in the suspension requests; that, as the Chief of Ordnance had not exercised the options to terminate under the contracts, the petitioner had no right to tender delivery of the raw materials on hand and to be paid for them at cost; and that the petitioner's chances for reimbursement for its damages by reason of the stopping of the deliveries by the Chief of Ordnance lay either in successful negotiations or suits for damages for breach of contract.

The settlement contracts themselves furnish further proof that the parties did not treat the suspension notices as exercises of the options given by the cancellation clauses. Supplemental agreements made in 1920, which provided for payment for the inventories under Contracts P12289–3034A and GA–126, were introduced in evidence and are printed in the record at pages 174–184. (See Special Finding 31, R. 71.) The supplemental agreement made under contract P12621–3124A was similar in form (Stipulation, R. 201). The fact that the War Department entered into these supplemental contracts is inconsistent with the contention that the inventories were delivered and

paid for under the cancellation clauses contained in the original contracts; for if the parties were proceeding under the cancellation clauses, the inventories would have been delivered and vouchered and paid for according to the terms of the original contracts and there would have been no occasion for any supplemental contracts. Furthermore, the language of these supplemental contracts shows that the parties considered that they were executing a partial rescission of the original contracts rather than carrying out their terms.

The settlement of the largest contract, P6489–1489Sa, was made by the War Department under the Dent Act, which was not passed until March 2, 1919. This method of handling the settlement is entirely inconsistent with any belief on the part of the Chief of Ordnance that he had exercised the option to cancel contained in the contract and that the settlement was merely the performance of the cancellation clause (Special Finding 30, R. 71).

c. On December 31, 1918, it was wholly uncertain whether the petitioner would reach any settlements of its contracts and whether, if it did, the settlements would involve the taking over of the inventories and payment for them at cost.

It is expressly found that on December 31, 1918, there was no way in which the petitioner could get cost for the inventories in question except by settlements with the United States. The materials were not salable at cost or at anything approaching cost (Special Finding 24, R. 70).

The suspension requests plainly contemplated negotiations looking toward some form of compensation to the petitioner on account of the stopping of further deliveries. At the end of the year 1918 no one could know what form any settlements would take with respect to inventories, or whether the parties to a given contract would agree on a settlement.

Nothing happened in 1918 which gave the petitioner any assurance that the settlements, if made, would include the

acceptance of the inventories by the Government and payment for them at cost. It was clear that the War Department did not want any more ammunition. There was nothing at the time to indicate that the War Department would adopt the policy which was later followed of taking over the enormous quantities of materials for ammunition which the various contractors had on hand, and setting up elaborate machinery for disposing of these materials, rather than leaving the materials in the hands of the contractors and making negotiated settlements with them as to their losses.

It is also to be noted that it was not until after 1918 that the War Department adopted a policy which permitted a partial settlement for an inventory where the parties had not reached a complete settlement of a contract.

The date when the War Department adopted the policy of partial settlements for inventories was March 6, 1919 (Special Finding 26, R. 70). As the petitioner had important claims under each of the contracts in addition to those relating to its inventories, and as, at the end of 1918, it was wholly uncertain whether the parties would ever agree as to the settlement of any of these other claims, the prospects at that time for a settlement of its inventory claims were equally uncertain.

In the event that the petitioner could not agree with the War Department as to the terms of the settlement of any contract, its remedy, if any, would be only by suit in the Court of Claims for breach of contract. The Comptroller of the Treasury and the Comptroller General could not settle such complicated, unliquidated claims for breach of contract.

Power v. *United States*, 18 C. Cls. 263.

In any such suit it is clear that the judgment would not be that the United States should take the inventories and pay cost for them, but the petitioner would keep the inventories and, if it prevailed, would obtain a judgment for a sum of money to cover the petitioner's loss because the United States had failed

to accept and to pay for the completed articles specified in the contracts.

United States v. *Behan*, 110 U. S. 338.
United States v. *United States Fidelity & Guaranty Co.*, 236 U. S. 512, 525.
Guerini Stone Co. v. *Carlin Construction Co.*, 248 U. S. 334, 343.

Furthermore there was doubt at the time and for several years afterwards as to whether a contractor could treat a suspension request as a breach of contract where it had assented to the request. The earlier decisions of the Court of Claims increased this doubt.

Dorris Motor Car Co. v. *United States*, 60 C. Cls. 68, 78.
Savage Arms Corporation v. *United States*, 57 C. Cls. 71, 85–86.

It was only after the decision of this Court in *College Point Boat Corporation* v. *United States*, 267 U. S. 12, which was handed down in January, 1925, that there was clear authority for treating such a request as a breach of contract in case negotiations failed.

d. Up to the time of the partial settlements made in 1920 the petitioner had no agreement that its inventories would be taken over and paid for at cost; and up to the time of the final settlements made in 1921–1922, the amount which the petitioner was to be paid was unliquidated.

The first proposition in this conclusion follows from the points which have already been stated and the last from the facts relating to the negotiations for settlement which are summarized above at pages 11–13. These facts show that on more than one occasion it appeared that any settlement of the petitioner's claims through the War Department was improbable, and that up to the time of the final settlements the amount of the claims was unliquidated.

2. Under the circumstances which have been stated the inventories should have been valued at their market value on December 31, 1918 ($231,615.43), and not at the amount ($732,088.62) which was realized for them in later years through the settlement agreements.

It is apparent from what has already been stated that what the petitioner had on December 31, 1918 was (1) inventories worth as merchandise $231,615.43, and in addition (2) claims for a much larger amount for reimbursement for the difference between the cost of its inventories and what they were worth as merchandise. The petitioner's chances for such reimbursement depended either on negotiations or on the outcome of a suit in the Court of Claims. As has been shown above, there was, on December 31, 1918, no ground for assurance as to the result of either negotiations or law suits. The petitioner contends that the Commissioner of Internal Revenue was not justified in valuing this merchandise as of December 31, 1918 at a figure which included its then present value plus the additional amounts eventually realized through the negotiations for the cancellation of the contracts.

a. The income which Congress intended to tax by the Revenue Act of 1918 was income which was so realized as to be available to the taxpayer according to ordinary business usage, and the petitioner's inventories were so available only at their market value.

The Revenue Act of 1918 imposed taxes running up to 82.4% of net income, which were payable during the year 1919. The inference is plain that Congress expected that taxpayers would have the income on hand out of which the taxes might be paid. It follows that the income intended to be taxed was something which, according to ordinary business practice, could be used to raise money with which to pay the taxes. Otherwise the result of the tax would in many cases

be bankruptcy. The inventories in question were available at their market value for this purpose, as a basis for credit or by sale. They were not available at a price which included the additional amounts realized by the settlements which were made in later years. It is clear that no one would purchase these inventories at more than their market value and it is equally clear that no one would lend on them an amount greater than their market value.

It is no answer to this argument that in the case at bar the petitioner succeeded in settling its contracts before it paid all of the taxes which were assessed by the Commissioner. The statute lays down a rule intended to be uniform, requiring payment of the taxes during the year 1919. It was only an accident in this case that the Treasury Department did not complete the audit of the petitioner's returns and the determination of its taxes until 1926. If the inventories should have been valued at $732,088.62 on December 31, 1918, the petitioner would have had no remedy if the examination had been completed and the additional taxes assessed in 1919.

b. The system of taxation contained in the Revenue Act of 1918 is based on an annual accounting period; and the petitioner's inventories should therefore be taken at their value at the end of 1918.

The decision of the Court of Claims was apparently based on the theory that the amount of the petitioner's taxes for 1918 might properly be kept open during the period of the statute of limitations and settled in the light of what the assets brought in later years within that period (see Opinion, R. 99–100). In support of this theory the Court relied on *Producers Fuel Co.*, 1 B.T.A. 202.

The objections to this treatment of the case at bar are that the Court below overlooked the general rule that taxes must be determined according to what takes place in the tax year, and also overlooked the fact that the *Producers Fuel Co.* case

is only a narrowly limited exception to this rule, and does not apply to the facts in the present case.

The general rule is stated as follows in a recent opinion of this Court:

> "The Federal income tax system is based upon an annual accounting period. This requires that gains or losses be accounted for in the year in which they are realized."
>
> *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264, 268.

A later decision to the same effect is *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359.

Producers Fuel Co., 1 B.T.A. 202, was a case in which a purchaser repudiated a contract to buy goods in December, 1920, and in the same month admitted liability for the breach, began negotiations for settlement, and set up a reserve for the amount of the damages. Settlements were made in January, 1921, by which the amounts to be paid were somewhat less than the reserve. The Board of Tax Appeals held that the purchaser might deduct a loss in 1920 but must substitute the amounts actually agreed on in settlement for the amount of the reserve. The decision has been limited to its special facts by later cases in the Board of Tax Appeals which the Court below did not notice. The limited scope of the decision is recognized in *Lucas* v. *American Code Co.*, Inc., 280 U.S. 445 at pp. 449–450, as follows:

> "The Board of Tax Appeals has held, in a series of well-reasoned opinions, that a loss occasioned by the taxpayer's breach of contract is not deductible in the year of the breach, except under the special circumstances where, within the tax year, there is a definite admission of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books."

The cases in the Board of Tax Appeals are collected in a footnote to the same opinion at page 450. It is clear that the *Producers Fuel Co.* case does not support the doctrine that an inventory may be valued at the end of a given year according to what is obtained for it in later years.

The Treasury Department and the Board of Tax Appeals have consistently ruled that a taxpayer in valuing his inventories on the "cost or market" basis must take the market value at the end of the year, if there is one, rather than the prices prevailing even a very short time later (A. R. R. 6016, III–1 C. B. 59. *Crown Manufacturing Co.* v. *Commissioner*, 12 B.T.A. 37).

In A. R. R. 6016 the Committee on Appeals and Review said, "The profits of a year are determined by the conditions existing at the close of that year. To take an inventory at the close of a fiscal period and to hold that inventory in suspense and price it under conditions existing 90 days after the taking of that inventory certainly would not reflect a true statement of the operations for the period closed, nor can such be considered good accounting practice." (III–1 C.B. 59, 61.)

In *Crown Manufacturing Co.* v. *Commissioner*, 12 B.T.A. 37, the Board of Tax Appeals held that in pricing an inventory at the end of 1920 a valuation based on a sale on February 7, 1921, did not show the market value at the end of the year where the market was fluctuating.

c. According to good accounting practice, which is recognized by the Revenue Act of 1918 and by the regulations as a standard, these inventories should be valued at their market value.

The material portion of the Revenue Act of 1918 is section 203 which reads as follows:

> "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Com-

missioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The regulations involved are Regulations 45, arts. 22-24, the material portions of which are as follows:

"Art. 22. Computation of net income.—Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year . . . The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income . . ."

"Art. 23. Bases of computation.—(1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income . . ."

"Art. 24. Methods of accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. . . .

(1) In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year; . . ."

The provisions quoted clearly state the following propositions: (1) that it is the income *realized by the taxpayer within the taxable year* which is to be taxed; and (2) that standard

accounting practice is ordinarily to be followed in determining this income.

According to standard accounting practice, inventories are a part of the quick assets of a manufacturing corporation. The excess of quick assets over current liabilities constitutes its working capital. The principal purposes of taking inventories and including them among quick assets are to give information to the management in laying out a financial policy; to give information concerning profits earned as a basis for dividends; and to give information to creditors as to what the company has with which to meet their claims. These purposes require that inventories should be treated as something which may be expected to be converted into current funds within a reasonable time for turnover. One of the principal reasons for listing quick assets separately is that creditors have as much right to know the availability of funds for meeting their debts when due as they have to know the ultimate value of the debts.

If the officers of the petitioner had applied to a bank for a loan on December 31, 1918, and had obtained it on a statement that the inventories on hand, taken on the basis of "cost or market whichever is lower" were worth $732,088.62, knowing that they were worth as merchandise only $231,615.43, could the transaction be defended as honest? Suppose that the owners of a corporation which had inventories under suspended contracts like the petitioner's had, at the end of 1918, sold their stock to the public through the mails and had put out statements for the purpose showing that they had inventories taken at cost or market whichever was lower, to the amount of $732,088.62. Suppose also that it appeared that the inventories had a market value of only $231,615.43, and that the balance of the alleged value was made up of claims against the United States for failure to perform the contracts which, by law, were not assignable and which would require years of time, difficult and uncertain negotiations, and

the expenditure of a large amount of money before anything could be realized from them. Suppose that under these circumstances the owners were indicted for fraudulent use of the mail and convicted. Would such a conviction be set aside on the ground that as a matter of law the inventories were properly valued at $732,088.62?

It is submitted that in the case at bar the inventories in question should be valued on the same basis for income tax purposes as they would be for other purposes and therefore that they should have been valued at their market value.

d. The regulations which relate to the valuation of inventories and to the proceeds of the settlement of claims on Government contracts require that these inventories be valued at their market value.

The regulations involved are Regulations 45, articles 1582–1584 as amended by Treasury Decision 3296, and Regulations 65, article 50, which was in force when the petitioner's tax was determined in 1926. Articles 1582–1584 of Regulations 45 are identical with articles 1612–1614 of Regulations 65 which are printed in full as a part of the petition filed in the Court of Claims (R. 19–23). The portions of these regulations which have a direct bearing on the issue are as follows:

> "Art. 1582. Valuation of inventories.— The Act provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income. It follows, therefore, that inventory rules cannot be uniform, but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. . . . An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

"The basis of valuation most commonly used by business concerns and which meets the requirements of the Revenue Act is (a) cost or (b) cost or market, whichever is lower. (For inventories by dealers in securities, see article 1585.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less cost of selling whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value . . .

"Art. 1584. Inventories at market.— Under ordinary circumstances, and for normal goods in an inventory, 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases (a) of goods purchased and on hand, and (b) of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost. Where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made

in good faith, or compensation paid for cancellation of contracts for purchase commitments. . . ."

The material portion of article 50 of Regulations 65 reads as follows:

> "Art. 50. When included in gross income.— Gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. See articles 21–24. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in that year, assuming that the money or property would have been income in the earlier year if then received . . . *Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined.*" (Italics ours.)

It is submitted that the regulations required the petitioner's inventories to be valued at their market value on December 31, 1918. In the Court below the respondent relied on article 1584 as supporting the Commissioner's valuation, claiming that the "firm sales contract" exception found in that article applied; that the cost of the goods was received in the settlements, and that therefore the regulations had been followed in effect by valuing the goods at the amounts so received. The Court of Claims, having first assumed that the *original contracts* entitled the petitioner to receive cost for these inventories (an erroneous assumption—see this brief, pp. 28–33), treated the case as one of "firm sales contracts" (R. 97). It is submitted that under the regulations the "firm sales contracts" exception does not apply.

In the first place, the sentence at the beginning of article

1584, in which the "firm sales contracts" exception is found, applies only to *normal* goods. As appears from article 1582, "normal" goods are those which are salable at normal prices or usable in the normal way. The petitioner's inventories were not "normal" goods; for the suspension requests had cut off all probability of using them in the normal way. It follows that the "firm sales contracts" exception is not one which applies to the petitioner's inventories. The provisions of the regulations which apply to these inventories are those in article 1582, under which an inventory may be valued at cost or market whichever is lower, and must conform as nearly as may be to the best accounting practice in the trade or business and must clearly reflect the income; and also the provisions of article 1584 to the effect that where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use the best available evidence of a fair market price at the date or dates nearest the inventory.

In the second place, the "firm sales contracts" exception in art. 1584, by its own terms, applies only to "goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e. those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory; . . ." The inventories in question differ from those described by the language quoted in three respects:

1. They were not goods on hand *for delivery*; for at the end of the year 1918 the parties knew that they would never be made into finished articles, and whether the United States would take delivery of them as a part of the settlement of the contracts was wholly uncertain. (See this brief, pp. 28–35.)

2. On December 31, 1918, the contracts were not "firm sales contracts" as defined by article 1584 in the words "those not legally subject to cancellation by either party." Performance under every contract had been stopped by agreement. If, as the regulations recognize, even an unexercised right to cancel destroys the exception, accomplished suspension of production is certainly inconsistent with a "firm sales contract."

3. The contracts as they apply to these inventories were not contracts "at fixed prices entered into before the date of the inventory." The only contracts in existence on December 31, 1918, which called for delivery of goods at fixed prices were the original contracts, and the goods which they called for were completed articles. The cancellation clauses which might have applied to the inventories were inoperative, as has been shown above. (See this brief, pp. 28–33.) In the events which happened, the only contracts which provided for the payment for these materials at fixed prices were the settlement contracts made in 1920–1922. These were not made "before the date of the inventory."

Furthermore, the possible claims which the petitioner had on account of the failure of the respondent to perform the original contracts are, under the regulations, clearly not income in 1918. Article 50 of Regulations 65, which was in force when the petitioner's taxes were settled, expressly provided:

> "*Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined.*" (Italics ours.)

This article is clearly in accord with the plan of taxation on which the revenue acts are based, as appears from a recent decision of this Court.

Burnet v. *Sanford & Brooks Co.*, 282 U. S. 359.

In that case the taxpayer carried on work under a dredging contract with the United States in the years 1913 to 1915. It reported current payments received under the contract in its returns for the years 1913–1916, inclusive. Subsequently it brought suit against the United States upon the contract, and in 1920 recovered a final judgment and collected it. The amount recovered in 1920 was the equivalent of the losses

suffered in doing the work in earlier years. The taxpayer contended that the transaction should be taken as a whole and that as it had made no net gain from the contract on this basis, the 1920 recovery was not income. The Court held that this recovery should be included in income for 1920, for the reason that the system of taxation contained in the income tax laws was based on annual accounting periods rather than on following through particular transactions.

> "The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis." (*Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359 at 365.)

In the case at bar the petitioner had at the end of 1918 inventories worth as merchandise $231,615.43, and also possible claims for breach of contract the value of which was uncertain. (See this brief, pp. 33–35.) By valuing these inventories at $732,088.62, the Commissioner included in income for the year 1918 $500,473.19 which was nothing but the proceeds of claims for the cancellation of the contracts which were not liquidated or settled until several years later. Under article 50 these proceeds should have been included in the income for later years and not in 1918 income.

e. The argument that valuing the inventories at market permits the petitioner to take a loss before it is sustained is not valid.

The objection to this argument is that it overlooks the distinction between *inventories*, which, according to the best

accounting practice as exemplified in the "cost or market whichever is lower" method, should be brought down annually to actual current values, and *capital assets*, which should be carried at cost less depreciation (or exhaustion or obsolescence) until they are sold or otherwise disposed of. The very purpose of the regulations in permitting the use of the "cost or market" valuation of inventories is to give the taxpayer the right to value them at prices less than cost when the market value is below cost.

C. The statutes and regulations should be liberally construed in favor of the taxpayer.

In the case at bar it is submitted that the statutes and regulations sustain the petitioner's contentions. If any doubt arises, however, they should be liberally construed in favor of the taxpayer (*Burnet* v. *Niagara Falls Brewing Co.*, 282 U. S. 648, at 654, and cases cited). It is respectfully submitted that the Court of Claims failed to observe this principle of construction.

VII.

THE AMOUNT OF INTEREST TO WHICH THE PETITIONER IS ENTITLED.

The statute involved is section 615 of the Revenue Act of 1928, which reads as follows:

> "(b) In any judgment of any court rendered (whether against the United States, a collector or deputy collector of internal revenue, a former collector or deputy collector, or the personal representative in case of death) for any overpayment in respect of any internal-revenue tax, interest shall be allowed at the rate of 6 per centum per annum upon the amount of the overpayment, from the date of the payment or collection thereof to a date preceding the date of the refund check by not more than thirty days, such date

to be determined by the Commissioner of Internal Revenue."

Of the total tax of $1,152,123.53 assessed upon the petitioner and paid by it, $642,914.24 was an additional tax which was paid on March 31, 1926. The balance, $509,209.29, was the original 1918 tax which was paid on or before June 15, 1919 (Special Findings 3, 4, 6, R. 59–60). The judgment of the Court of Claims orders a refund of $160,978.83 with interest. The difference between the total additional tax ($642,914.24) and the refund ordered ($160,978.83) is $481,935.41. Any additional recovery to which the petitioner is entitled should, therefore, be treated, to the extent of $481,935.41, as a recovery of an overpayment of the additional tax which was paid on March 31, 1926, and any amount in excess of that as a recovery on account of the original tax paid on June 15, 1919.

CONCLUSION.

For the reasons which have been stated, it is submitted that in addition to the relief already given in the Court of Claims, the valuation of the petitioner's inventories under the contracts with the United States on December 31, 1918, should be reduced by the difference between the figure used by the Commissioner ($732,080.62) and their market value ($231,615.43) or $500,473.19; that the petitioner's net income for 1918, as determined by the Commissioner, should be reduced by the same amount; that such income should be further reduced by $327,937.35 because of the deduction to which the petitioner is entitled on account of the cost of its buildings erected on leased land; and that the judgment entered for the petitioner in the Court of Claims should be increased by an amount equal to 82.4% of such reductions of income together with interest as provided by the statute.

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APPENDIX.

Regulations 45 (1920 ed.) articles 109, 143, 161, 162 and 165 provide as follows:

Art. 109. Rentals. — Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvement made, this deduction shall take the form of an allowance for depreciation. (See article 48.)

Art. 143. Loss of useful value. — When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss for the year in which he takes such action the difference between the cost or the fair market value as of March 1, 1913, of any asset so discarded (less any depreciation sustained) and its salvage value remaining. This exception to the rule requiring a sale or other

disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property must be prematurely discarded, as, for example, where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income. But see articles 181–189.

Art. 161. Depreciation.—A reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date. See further articles 839 and 844.

Art. 162. Depreciable property.—The necessity for depreciation allowance arises from the fact that certain property used in the business gradually approaches the point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the property becoming inadequate to the growing needs of the business. It does not apply to inventories or to stock in trade; nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provision for this being made in the statute. See articles 201–237. Property kept in repair may, nevertheless, be the subject of a depreciation allowance. See article 103. The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business. No such allowance may be made in respect of automobiles or other vehicles used chiefly for pleasure, a building used by the taxpayer solely as his residence, nor in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

Art. 165. Method of computing depreciation allowance.—The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return.